

Central Intelligence Agency



Washington, D. C. 20505



Ozal visit

29 March 1985

The Turkish Economy Under Ozal

Summary

Prime Minister Ozal's political future is tied to the success of his economic program. Although Ozal's government is in no immediate danger, we believe it will come under increasing pressure from the military and the public if the economy fails to improve markedly under his direction. Ozal's economic program has helped to strengthen Turkey's balance-of-payments position, but inflation and unemployment remain troublesomely high. While soaring exports and worker remittances helped to reduce the current account deficit by 20 percent, to \$1.4 billion last year, the annual inflation rate rose to over 50 percent. The outlook for 1985 is mixed. We expect the economy, especially exports, to grow at a good clip, but unemployment probably will creep even higher and inflation abate only modestly, if at all. ~~(S NF NC OC)~~

Ozal will be looking for help from the US during his visit here next week, perhaps in rescheduling debt and lowering barriers to imports of Turkish goods. In our view, the failure of his program would jeopardize the long-term prospects for economic reform and possibly even endanger the democratic process in Turkey. ~~(S NF NC OC)~~

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APPROVED FOR RELEASE
DATE: JUL 2000

EUR M85-10063
[REDACTED]

Introduction

Prime Minister Ozal won election on 6 November 1983 in part on the strength of his promise to revive the Turkish economy, which had begun to slip after making a remarkable recovery from the economic crisis of the late 1970s. Ozal pledged to revive the economic stabilization program of 1980 -- for which he, as economic czar under the conservative government of Prime Minister Suleyman Demirel, had been largely responsible -- and to promote growth by making the economy more responsive to market forces. The Turkish military, which handed over the reins of government to Ozal, has permitted him a largely free hand in the running of the economy, in contrast to the decisive role it still plays in the formulation of security policy. ~~(S)~~

Ozal has made commendable progress in whittling down the government's traditionally huge role in the Turkish economy. He is following a long-term strategy, however, and the immediate results have been mixed. In particular, improvements in economic growth and the balance of payments have been offset in the public mind by higher inflation and unemployment. With Turkey's foreign debt service scheduled to jump sharply in 1985, Ozal likely will be seeking additional aid during his visit here next week. ~~(C)~~

Ozal's Economic Program

Ozal acted quickly upon taking office to reinvigorate the 1980 stabilization program, which combined economic liberalization with fiscal and monetary austerity. His stated intention was to reduce inflation, promote economic growth through exports, attract sorely needed foreign investment, and shrink the state's large role in the economy. ~~(S)~~

Ozal has taken several important steps to liberalize and strengthen Turkey's balance of payments, including reducing many import restrictions, providing new incentives for exports, and abolishing most foreign exchange controls. Products may now be freely imported unless they are specifically listed as being prohibited or subject to licensing; previously, all imports were prohibited unless they were specifically listed as being importable. New regulations this year have lowered many tariffs and exempted several products from duty altogether. To encourage exports, Ankara shortened the list of exports subject to licensing and reduced bureaucratic obstacles. Exporters are now permitted to keep 20 percent -- up from 5 percent -- of their foreign exchange earnings, and companies with over \$30 million in exports in 1983 have additional incentives in the form of special

credit funds, duty-free imports, and foreign exchange. In addition, commercial banks are free to buy and sell foreign currency within a certain range around the official rate set by the Central Bank, while Turkish citizens are free to hold foreign currency and to travel and spend abroad. Last but not least, daily exchange rate adjustments have offset Turkey's high inflation rate, keeping exports competitive in foreign markets. ~~(C)~~

Even more importantly, Ozal has begun tackling the serious economic structural problems, particularly the oversized, inefficient bureaucracy and the pervasive role of the government in the economy. Because these reforms challenge Turkish traditions associated with Ataturk, the founder of modern Turkey, they are meeting the greatest resistance from the bureaucracy. Nevertheless, Ozal already has carried out highly successful sales of revenue shares in the Bosphorus Bridge and Keban Dam to private investors and plans next to sell shares in the national airline, THY. In addition, a bill has been presented to the Parliament that would privatize the largely-nationalized mining sector and open it to foreign investment. ~~(C)~~

Last June, Ozal carried out a major reorganization of the bureaucracy and the State Economic Enterprises (SEEs), a move intended to increase efficiency and strengthen his control over the public sector. More than half of the committees, boards, and commissions within the various ministries were abolished. Moreover, the new framework law for the SEEs -- which replaces 32 separate laws -- imposed experience requirements for management positions. The notoriously inefficient SEEs dominate the Turkish economy, accounting for over half of all industrial production. In recent years they have accounted for almost all of the government budget deficit as well as the much larger public sector borrowing requirement. The SEEs demands on the government budget and the credit markets are to be reduced by charging market prices for their products. ~~(C)~~

Ozal has singled out infrastructure development as a major responsibility of the state. Inadequate infrastructure -- in particular an insufficient supply of electricity -- has been a significant hinderance to economic development. Ozal consequently has gone ahead with the massive Ataturk Dam project in southeastern Turkey and has given guarded support for the development of nuclear power -- an effort begun under the military -- although Ankara has yet to decide which foreign consortium will build the first plant. ~~(C)~~

The remainder of Ozal's program focuses on fiscal and

monetary measures aimed at reducing government deficits and inflation. To promote saving and investment he has reduced personal and corporate income taxes -- although the rates are still high -- and introduced a value-added tax of 10 percent. The implementation of the VAT was confusing to many Turks, even though they generally support the tax. With regard to monetary policy, Ozal's objectives are to maintain positive real rates of interest while gradually slowing the growth of the money supply. (C)

Ozal's Balance Sheet

Ozal's efforts appear to have produced positive results in two key-areas: economic growth and the balance of payments. Real GNP expanded almost 6 percent last year, up from 3.2 percent in 1983. Industry and commerce led the way, with growth rates of 8.7 percent and 7.6 percent, respectively, while agricultural output grew 3.6 percent. Meanwhile, the current account deficit narrowed from \$1.8 billion to \$1.4 billion, in spite of an increase in interest payments and the liberalization of imports and foreign travel. (C)

The improved GNP and current account performances were both due in large measure to a surge in exports. After near-stagnation in 1983, exports rose 25 percent to \$7.4 billion in 1984. Exports of industrial goods soared nearly 40 percent and now equal nearly three-fourths of total Turkish exports. With imports rising 16 percent to \$10.3 billion, the trade deficit held steady last year. Benefitting from the moderation in oil prices, imports of crude oil rose only 4 percent to \$3.4 billion; imports of consumer goods nearly doubled but still accounted for just 4 percent of total imports. The improvement in the current account deficit resulted from a 30-percent rise in the invisibles surplus -- due in turn to a sharp increase in worker remittances, following two years of substantial declines. (See Table 1) (C)

The capital account of the balance of payments showed some modest improvement. Direct investment in Turkey nearly doubled even though in absolute terms it remains at very low levels. Ozal has encouraged foreign investment by eliminating many restrictions on the repatriation of profits and reducing red tape and other obstacles. Some revisions in the current law governing foreign investment are under review as part of an effort to attract further foreign capital. In addition, Ozal has the confidence of the international financial community, according to several banking sources, enabling Turkey to attain increasing amounts of credit. Ankara's recent difficulties in negotiating a \$500-million credit were mainly the result of a new type of loan

facility being used. ~~(C NF)~~

Ozal's program thus far has had little success in reducing inflation and unemployment, partly because he has failed to meet his own fiscal and monetary targets:

- The inflation rate in 1984 was 52 percent -- up from about 31 percent in 1983 -- partly because of substantial price increases in several state-produced products. It has continued strong in the first two months of 1985, rising at an annual rate of 68 percent in the first two months of 1985. The acceleration in the inflation rate represents the introduction of value-added tax in January. The February rate was running at an annual rate of 48 percent.
- Unemployment has climbed to roughly 21 percent as growth in the labor force has outstripped gains in civilian employment. The job outlook is uncertain because of the continued growth in the labor force and because many firms -- especially smaller ones -- are in severe financial difficulty. ~~(C)~~

While Ozal can place some of the blame on the loose monetary policies of the military government after he resigned as deputy prime minister in mid-1982, and to long overdue price hikes in SEE products, he nevertheless has pursued relatively accommodating monetary policies. Money supply grew by 50 percent in 1984, and Ankara ran into trouble with the IMF last summer because it had exceeded the Fund's monetary targets. In response to the IMF's threatened suspension of credit to Ankara, Ozal now has raised interest rates and brought money growth back into line with newly agreed upon targets. ~~(S NF)~~

Ozal's decision to cut income and corporate taxes, as well as the continued depreciation of the lira, have helped to keep the budget deficit very high. The fiscal deficit for 1984 is estimated by the IMF to be around \$2.5 billion, or 5.1 percent of GDP, while press reports and new government figures indicate it is much higher -- close to 6 percent of GDP. Inadequate tax revenues appear to be a major problem -- tax revenues account for just 16 to 18 percent of GNP, one of the lowest rates in the OECD. The recently introduced VAT should help to raise revenues, despite the short-term inflationary effects. ~~(C NF)~~

Outlook

Ozal's political future is inextricably intertwined with

Turkey's economic progress or lack thereof. If the economy fails to prosper under his direction, Ozal's government will almost certainly come under increasing pressure from the military and the public and could eventually fall. The Prime Minister is already under strong attack for his failure to control inflation, reduce unemployment, or relieve the financial stresses of many private business firms. The political opposition began calling for the formation of a "national unity" coalition this past fall to replace him. The two corruption scandals which rocked his government within a three-month period this past winter heightened dissatisfaction with Ozal, as did the rather chaotic implementation of the VAT in January. ~~(C NF)~~

The outlook for 1985 is mixed, and it could end up as a repeat of 1984. GNP growth should remain strong at around 5 percent, while we expect the current account deficit to narrow somewhat to about \$1 to \$1.2 billion. Exports, we believe, will increase by 10 to 15 percent and imports at a slower rate, thus reducing the trade deficit slightly. The invisibles balance also should improve a bit, despite a rise in interest payments. On the negative side, unemployment is likely to creep even higher because of strong growth in the labor pool, while the inflation rate abates only modestly to perhaps 45 percent. ~~(C NF)~~

Ankara's grace period on rescheduled foreign debt essentially ended last year, with the result that principal repayments will jump sharply in 1985. Total service costs on medium and long-term debt will exceed \$3 billion this year -- about 30 percent of current account earnings -- and will remain near that level for the remainder of the 1980s. As a result, Turkey will continue to be dependent on foreign aid from the West as well as require new borrowing in private financial markets. ~~(C)~~

Ozal's dilemma is that his program is aimed at the long run, but he needs short-term results to avoid jeopardizing his government and even the democratic process in Turkey. While we believe he is in no immediate danger, the mixed economic outlook for 1985 means that Ozal's political problems will not abate in the near future and that he will need all of his tactical skills to fend off critics and keep his program on track. Should Ozal be forced from the scene, Turkey would lose its most influential champion of badly-needed economic reforms, and successor regimes would almost certainly lack Ozal's commitment to long-term economic restructuring. The failure of the Ozal program could also contribute to a rise in terrorism because impoverished and unemployed young people would be potential recruits for extremist organizations. Ozal's failure could also lead to the

disintegration of his party and a return to the highly factionalized and chaotic politics of the late 1970s. In those circumstances, the military might decide it had to step in and replace him, particularly if the generals concluded that Ozal's economic program had failed to control inflation -- the key indicator for them -- and that he had lost the confidence of the international financial community. (~~C NF~~)

Implications for the United States

Ozal will be looking for help in dealing with his economic and political problems in his visit here. He may raise the issue of rescheduling debt owed to the US -- perhaps including forgiveness of FMS credits -- as well as try to gain US support in rescheduling debt owed to the IMF. Because another request for concessionary debt relief might damage Turkey's growing international creditworthiness, Ozal probably will want the issue treated as a commercial operation intended only to smooth out the bulge in repayments due in the next several years. (~~S NF NC OC~~)

Ozal is likely to complain that the strength of the dollar and high US interest rates have added to Turkey's debt burden. A major portion of external debt is denominated in dollars, with military credits forming a significant portion of the debt owed to the United States. Consequently, he probably will ask for increased US economic aid and security assistance, and for more concessionary terms. He is also likely to press Turkey's case that export growth is essential to the country's ability to meet its external debt obligations, and that US restrictions on Turkish textile products hinder export growth. (~~C NF~~)

TABLE 1

Turkey: Balance of Payments
(According to Old and New Methodologies¹)

	<u>1982</u>		<u>1983</u>		<u>1984</u> (Provisional)		<u>1985</u> (Projected)	
	Old	New	Old	New	Old	New	Old	New
Trade balance	-3097	-2660	-3507	-2990	-3623	-2958	-2668	
Exports	5746	5746	5728	5905	7134	7389	8663	
Imports	-8843	-8406	-9235	-8895	-10757	-10347	-11331	
Balance on invisibles	1844	1799	1314	1162	1191	1516	1658	
Tourism (net)	262	224	284	292	125	271	320	
Worker remittances	2187	2189	1554	1569	1881	1901	1900	
Interest payments	-1565	-1465	-1512	-1441	-1770	-1578	-1550	
(before debt relief)								
Other (net)	961	851	988	742	955	922	988	
Current Account Balance	-1252	-861	-2193	-1828	-2432	-1442	-1010	

¹ In consultation with the IMF, Turkey has just revised its balance of payment methodology in order better to reflect underlying transactions. One major difference is that imports are shown fob rather than cif, while several changes have been made in the recording of invisible transactions. For example, import transportation costs paid to Turkish flag carriers will no longer appear in the balance of payments. Also, goods sent home by Turkish emigrant workers ("imports with waiver") will be shown as being financed by a unilateral transfer rather than a capital flow, and thus will not add to the current account deficit. The net effect of these changes is to reduce significantly the reported current account deficit -- by as much as \$1 billion in 1984. All balance of payments references in the text are based on the new figures.

~~This table is UNCLASSIFIED~~

TABLE 2
Turkey: General Economic Indicators

	1982	1983	1984 ¹	1985 ²
Real GDP growth (percent)	4.3	3.8	5.7	5.1
Inflation (percent)	27.0	30.7	52.1	45.0
Unemployment (percent)	17.4	20.0	21.0	22.0
Budget deficit (percent of GNP)	2.1	3.3	6.0	5.5
Public Sector Borrowing Requirement (percent of GNP)	7.0	9.0	NA	--
External Debt * (billion US \$)	17.7	18.3	20.0	23.0
Debt Service ratio (as a (Percent of current account earnings)	26.8	31.8	30.0	33.0

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¹preliminary

²projected

*Excludes military debt. The US Embassy estimated military debt owed to the United States at about \$2.6 billion at the end of 1983.

TABLE 3

Turkey: Projected Debt Service Payments
on Existing Medium- and Long-Term Debt, 1983-88 ¹

	(million US dollars)				
	1984	1985	1986	1987	1988
Total Debt service payments	2,645	3,094	2,964	2,883	2,756
Principal	1,577	2,125	2,103	2,144	2,185
Interest	1,068	969	861	739	571
International organizations, excl. IMF	435	492	582	662	676
Principal	205	261	313	364	404
Interest	230	231	269	298	272
Bilateral lenders					
OECD countries	837	825	756	691	612
Principal	601	624	585	548	496
Interest	236	201	171	143	116
Other countries	163	123	141	145	136
Principal	119	81	105	116	112
Interest	44	42	36	29	24
Commercial banks	734	1,093	914	849	849
Principal	380	787	679	679	746
Interest	354	306	235	170	103
Private sector	81	138	106	92	81
Principal	51	109	85	76	69
Interest	30	29	21	16	12
IMF ²	395	423	465	444	402
Repurchases	221	263	336	361	358
Charges	174	160	129	83	44
Memorandum item:					
Debt relief	580	150	-	-	-
Principal	580	150	-	-	-
Interest	-	-	-	-	-

Sources: Data provided by the Turkish authorities and IMF staff estimates.

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¹ Payments are shown after debt relief. Projections are based on disbursed and undisbursed external debt as of December 31, 1983.

² Based on purchases outstanding as of December 31, 1983 and on the assumption that all purchases will be made under the current stand-by arrangement.